

TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE

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SUBJECT: External Equities – Equity Manager Rating Criteria

ITEM NUMBER: 8

ATTACHMENT(S): 1

ACTION: \_\_\_\_\_

DATE OF MEETING: November 6, 2002

INFORMATION: X

PRESENTER(S): Elleen Okada

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At the March 6, 2002 Investment Committee Meeting, the Committee directed staff to provide a detailed description of the criteria that the External Equity staff considers and the process that is used to evaluate the external equity managers. The External Equities Monitoring Procedures (Attachment 1) describe this process and govern staff's evaluation and rating of each of the managers. These procedures were established by staff, and approved by the Chief Investment Officer, to implement the policies developed by the Board. Staff may amend the procedures from time to time as necessary.

Staff will be available to address any questions or provide additional information as necessary.

## **EXTERNAL EQUITIES MONITORING PROCEDURES**

### **OVERVIEW**

The time horizon for the performance evaluation will be over a market cycle, generally lasting between three and five years. A shorter period may be used when a manager's performance becomes significantly inferior to the other managers in a corresponding style grouping, and/or to a relevant benchmark. External Equities/Corporate Governance Unit Investment Officers will implement the monitoring procedures. The stages of monitoring the equity manager(s) are a combination of art and science. It is important that judgment be used in all facets of the monitoring program. The necessary judgment results from experience in the employment of analytical techniques, as well as knowledge of manager personnel, investment management style execution and the understanding of the overall investment management plan. If warranted, CalSTRS may consider modification of the criteria in qualitative as well as quantitative aspects. The period for continued evaluation of the manager(s) will be recommended by staff and approved by the Director of Administration and External Relations and the Chief Investment Officer (CIO).

### **COMMUNICATION**

The Investment Officers engage in frequent communication with the managers. Communication provides a means of affirming the managers' investment strategies, awareness of organizational structure, understanding the managers' philosophy, objectives, portfolio construction, re-balancing methods, trading and an avenue for discussing investment issues. Meaningful and effective communication enables CalSTRS to make informed and effective decisions regarding the investment managers who have the delegated investment authority over its assets.

The monitoring periods established are monthly, quarterly, and annually and will be triggered over rolling six-month periods. The managers' status will be evaluated based on, but not limited to, the following items:

- Manager's returns versus the objective (historical as well as rolling six months);
- Manager's performance versus other CalSTRS managers in same style category;
- Performance attributions of active management;
- Manager's performance and rank compared to a universe of like managers (i.e., TUCS Universe, InterSec Universe);
- Style drift and/or change in the investment process of the manager;
- Personnel changes of the manager;
- Administration and/or operational problems;
- Market observation/analysis;
- Other factors that staff deem appropriate.

## **GENERAL DESCRIPTION**

### **Satisfactory**

The manager(s) met the established performance objective (200 basis points for active international, 150 basis points for active domestic, and 100 basis points for domestic enhanced) over appropriate periods evaluated. In addition, the manager(s) has added value over the benchmark and the portfolio is ranked within the top half of a universe of like managers.

**Needs To Improve** (This stage has three levels: 1, 2 & 3, with Level 1 being the most benign and Level 3 as the most serious.)

The purpose of this stage is to provide enough review time to allow an active manager to recover. Communicating with the manager by phone and face to face meetings with the manager will take place during this stage. This stage is both quantitative and qualitative. Managers may be placed in the probation stage at any level.

#### **Level 1:**

- The manager under performed the performance objective up to 300 basis points for Active International;
- The manager under performed the performance objective up to 200 basis points for Domestic Enhanced;
- The manager under performed the performance objective up to 250 basis points for Active Domestic;
- The period evaluated will be a rolling six months snap shot of performance and historical performance when available. The portfolio continues to be in the top half (50<sup>th</sup> percentile or better) of a universe of like managers (TUCS Universe/InterSec Universe).
- The manager's performance is competitive with the other CalSTRS managers in the same category.
- Other considerations included , but not limited to:
  - portfolio attributions;
  - portfolio style;
  - portfolio risk;
  - market conditions;
  - And other factors that staff may deem appropriate.

#### **Level 2:**

- The manager under performed the performance objective from 300 up to 600 basis points for Active International;
- The manager under performed the performance objective from 200 up to 400 basis points for Domestic Enhanced;
- The manager under performed the performance objective from 250 up to 550 basis points for Active Domestic;

- The portfolio is in the top half of a universe of like managers (TUCS Universe/InterSec Universe).
- The manager's performance lags the other CalSTRS managers in the same category.
- Other considerations included, but not limited to:
  - portfolio attributions;
  - portfolio style;
  - portfolio risk;
  - market conditions;
  - And other factors staff may deem appropriate.
- Staff begins intense communications with manager to discuss under performance. Staff will explain to the manager(s) the monitoring stages and how the process works.

### **Level 3:**

- The manager under performed the performance objective from 600 up to 900 basis points or for Active International;
- The manager under performed the performance objective from 400 to up 600 basis points or more for Domestic Enhanced;
- The manager under performed the performance objective from 550 to 850 basis points or more for Active Domestic;
- The portfolio is in the bottom half of a universe of like managers (TUCS Universe);
- The manager's performance compared to other CalSTRS managers in the same category places the firm in the bottom quartile of the style universe (TUCS Universe);
- Other considerations included , but not limited to:
  - Portfolio attributions;
  - portfolio style;
  - portfolio risk;
  - market conditions;
  - And other factors staff may deem appropriate.
- Staff communicates with manager to discuss under performance; an in-person meeting, either on-site or at CalSTRS' offices will be scheduled. A time frame will be decided for improvement; the manager's view of the market and the style category will be considered when deciding this time frame; other issues may also be addressed. Staff will reiterate the CalSTRS monitoring stages, now emphasizing the serious nature of being in Level 3.

### **WATCH**

The purpose of Watch is not performance driven, but rather by changes to the firm, personnel, ownership, etc. (i.e., a manager could be in any of the status with a check in the Watch column because of changes in organization.

## **PROBATION** (The probation stage is formal)

The evaluation of the manager shows that the under performance is excessive and portfolio value is in jeopardy and/or unlikely to be recovered. This is based on quantitative as well as qualitative considerations. A written letter will notify the manager of placement in probation and another in-person meeting will be scheduled.

- The manager has continued to under perform the portfolio objective in all levels of the Needs Improvement stage.
- In addition, active management severely hurt performance over the down periods, the portfolio's style rank falls in the last quartile of like managers, and there is significant under performance relative to other funded managers in the same style.
- Manager will meet with staff to address the under performance. The manager's task is to provide staff with information that will reaffirm staff's confidence in the manager's investment process and personnel.
- Once the review period has been agreed upon, the performance slump must be corrected within the designated evaluation period. The manager will be evaluated during and at the end of the probation period. If warranted, staff may recommend an extension of the probation period to the CIO or designee.
- If there is no indication of improved performance during the designated period, and no extension of probationary status is appropriate, staff will recommend termination to CIO or designee.

## **TERMINATION:**

Termination will be recommended for under performance versus the portfolio objective as well as any or all of the following:

- The manager's formal probation evaluation shows inferior performance compared to the performance objective, as well as other like managers in the same style;
- Negative performance attribution of active management;
- Manager's universe style ranking remains in the bottom quartile;
- Substantial changes occurred in the ownership structure of the investment management firm;
- An unapproved/or unsuccessful change in the portfolio manager or in the portfolio management style or its operation at the firm;
- Continued problems in client service, corporate governance or operational/accounting aspects of the CalSTRS account relationship;
- Loss of confidence in the manager's ability to manage the portfolio and deliver results in a way that furthers the objectives of the investment management plan.

Staff will present an analysis to the CIO or designee in conjunction with the termination recommendation that will recommend a suitable plan for re-deployment of the assets. Style weightings, performance of available managers in the style, trading costs, as well as the overall investment management plan will be considered.